Five Years of Reform

A Brief Retrospective

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Looking back at the hard road to reform in Eastern Europe and the former Soviet Union since 1989, it is not easy to draw up a balance sheet. It is clear that important progress has been achieved in creating democratic institutions and transforming the centrally planned economies into market systems, but the economic and social cost of transition has been much higher than anticipated. A prolonged economic downturn, high levels of unemployment, sharply reduced social security, widening income and wealth differences, falling health standards and the rise of organised crime, have all contributed to frustration, disillusion and mounting political tensions. As a result, the current mood among the Eastern European populations is very different from the enthusiasm and hope which were raised by the fall of the Berlin Wall in late 1989.

The dramatic divergence between expectations and reality has probably been the single most important factor behind the recent turnaround in the political and social climate in the region. Among economists and policymakers there is an almost universal consensus that the recession has been much deeper and longer than initially expected, and that the transformation has not yet delivered on many of its promises.

1 Infant capitalism?

It cannot be denied that the Eastern European countries have gone a long way since they started their transition to capitalism. Democratic and pluralistic political systems have been established in all of them and there is little question of reversing the trend towards the market economy. The straightjacket of central planning and state controls was dismantled: prices have been liberalised, domestic currencies are convertible, consumers and producers are essentially free to make decisions according to their preferences. Inflation has been greatly reduced and endemic shortages eliminated. A large part of output is now produced in a dynamic private sector, and domestic markets offer a large variety of goods and services, comparable to that in Western countries. According to official national statistics, the non-state sector's share in

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gross domestic product (GDP) already exceeds 50 per cent in most countries, an indicator of the enormous distance they have covered since 1989 when the share was generally less than 5 per cent. Even if these statistics must be treated with some caution, because the rules of statistical reporting and sectoral classification are not always clear and consistent, the radical change in the ownership structure is clearly evident.

The governments of transition countries have also made considerable progress in integrating their economies into the global market economy: most of their foreign trade is now conducted with developed market economies at international prices and in convertible currencies, and their international links have been further strengthened by inflows of foreign direct and portfolio investment. Many new market institutions have been established and developed, such as stock exchanges, monetary and credit instruments, anti-monopolistic regulations, bankruptcy legislation, etc. By the end of 1994, most Eastern European economies had passed the low point of the economic recession, and the long-awaited recovery appeared to be under way.

But all the achievements notwithstanding, there have also been failures and disappointments; in fact, after five years, capitalism in the transition economies was still in its infancy: growing fast, but still immature and turbulent.

2 Transitional recession: too deep, too long

Perhaps the most disturbing and unexpected outcome of the 1989 revolutions was the transitional recession which depressed output and employment well below pre-transition levels. The official statistics show that the cumulative contraction of output between 1989 and 1993 in the transition economies was on a massive scale and unprecedented since the Great Depression of 1929–33. The recession was particularly dramatic in Bulgaria and Romania, the two Eastern European countries commonly considered as being the least prepared for market reforms, and in nearly all the countries of the former Soviet Union. Another common feature is that the cumulative fall of (gross) industrial output was larger, generally by more than a half, than the fall of gross domestic product (GDP), and by the end of 1993 it exceeded 50 per cent in the worst cases (Bulgaria, Romania, Russia, Ukraine and the Baltic states).

What was surprising about the recession was not the fall of output itself, because some recession had indeed been anticipated, but rather that it was so deep, so widespread and so persistent, and that the subsequent adjustment on the supply side was so weak. Official forecasts which accompanied the launching of the stabilisation-cum-reform programmes typically predicted a temporary and relatively mild contraction of output, followed by a strong recovery fuelled by efficiency gains, the expansion of private business activities, and inflows of foreign investment. In reality, however, the behaviour of output followed an L-shaped pattern, instead of a U-shaped one.

A number of possible explanations of the transitional recession have been suggested over the last few years.[2] They range from Keynesian demand-deficiency to Schumpeterian institutional interpretations, from concepts of structural rigidities and distortions typical of Soviet-type economies to views regarding the recession as a statistical artefact. None of them is fully convincing, but considered jointly they allow for some conclusions.

First, it should be noted that the recession was real and not imaginary: while there seems to be no doubt that the official statistics do tend to overestimate the extent of the actual fall in output, it may also be argued that the margin of error is probably smaller than commonly believed (Rosati 1994). Second, the recession was the joint outcome of a combination of factors working both from the demand and supply sides; but the adverse impact of stabilisation programmes on domestic demand appears to be quite substantial. With the benefit of hindsight, it can be argued that the stabilisation policies were probably too restrictive, as they were guided by a mistaken judgment of the initial degree of macro-economic disequilibrium. Third, it might have been expected that the shift away from communism would release large efficiency gains which would generally work in favour of output

[2] See, for example, Chadha *et al.* (1993), Kornai (1993) and Blanchard *et al.* (1991).

expansion rather than contraction (Leibenstein 1978: 17–38); that these gains have not materialised underlines the excessive optimism that prevailed in 1989 as to the responsiveness of the supply side of the transition economies. Whether micro-supply responses could have been stronger with a different set of policies is an open question.

3 Structural unemployment

It is a well established proposition of traditional comparative economics that the near-full employment levels observed under central planning were artificially achieved because of low work discipline, an ideological commitment to full employment, and low wages. Large-scale lay-offs during the transition were therefore predicted, but it was also assumed that rapidly increasing demand for labour in the expanding service and private business sectors would absorb most of the excess manpower in industry, and that unemployment would remain moderate. In reality, the jobless rate in most Eastern European countries is well over 10 per cent of the labour force and has remained high, despite the emerging recovery of output.

An important message from labour market statistics is that not only are unemployment rates high in the transition economies, but also that there has been only a small reduction in excess employment (as indicated by the difference between the cumulative change in GDP and the cumulative change in employment). In Bulgaria, Slovenia, Hungary and Poland employment levels have fallen broadly in line with the fall of output, thus leaving the initial level of overemployment practically unchanged; in all the other countries, but especially in the former Soviet republics and Yugoslavia, the level of overemployment has increased, with obviously negative implications for labour productivity and wages.

Since the major reason for high unemployment has been the transitional recession, the recovery might in principle have been expected to at least alleviate the problem. Unfortunately, the emerging recovery cannot be counted on to radically improve the labour market situation, because the flow of new jobs is likely to be broadly offset by new entrants to the pool of unemployed coming from schools, an overmanned agricultural sector and shrinking state enterprises. As a result, the transition countries are likely to have to live with double-digit unemployment rates for several years to come.

Not only is the economy likely to suffer from the waste of manpower resources, but social and political stability may be endangered if too many people are unemployed for too long.

4 Persistent inflation

High rates of inflation and widespread shortages were characteristic of the final days of the central planning system. Liberalisation of prices and the initial devaluation of domestic currencies further added to inflationary pressures; in fact, the corrective inflation in most countries strongly overshot the levels envisaged in the stabilisation programmes. To restore fundamental price stability was thus one of the central objectives of the reformist governments. Experience has shown that reducing inflation from near hyperinflation levels to manageable proportions is a relatively easy task, and can be done quickly with standard measures of financial restraint implemented within a credible and consistent programme. However, most of the Eastern European countries which have succeeded in lowering inflation to 20–40 per cent per annum, seem to be finding it very difficult to reduce it further to one-digit rates.

The persistence of inflation at so-called moderate levels cannot be explained easily with standard theories. The growth of money supply does not seem to have been a primary inflationary factor, because it has generally lagged behind the consumer price index in all Eastern European countries (except the Czech Republic where, however, inflation is the lowest in the region), and even more so in Russia and the other Commonwealth of Independent States countries. Also, there is no uniform pattern in the impact of budget deficits: although there seems to be a clear link between fiscal deficits and inflation in Russia and in Ukraine, the evidence is less clear for Eastern European countries. Wages have been kept under control throughout the region, generally increasing less than consumer prices.

The nature of the current inflation appears to be different from that observed in the initial stages of the transition, when the liberalisation shocks, excess demand, and monetisation of fiscal deficits played the most important roles. Moderate inflation seems to be caused chiefly by inertial mechanisms, such as various indexation schemes for wages and pensions, frequent foreign exchange rate adjustments, periodic increases of key commodity prices (mostly energy and food), and inflationary expectations. Attempts to stop such inflation with the standard instruments of tight monetary policy tend not to be very effective, especially when inflows of short-term capital boost the domestic money supply under pegged exchange rates (Czech Republic, Poland). A conservative monetary policy is still needed, but it should be combined with other measures which would dampen inflationary expectations through the breaking up of inertial mechanisms.

5 Enterprise reform and privatisation

Policymakers in the transition economies were clearly aware of the systemic weaknesses of traditional state enterprises and seem to have recognised that, unreformed, they were likely to behave in a perverse way in a market environment. In the initial stage, these dangers were to be avoided through rigid tax-based incomes policies, and thereafter through privatisation. And yet the composition of the stabilisation packages in most countries suggests that they were based on an implicit assumption that the reaction pattern of state enterprises to stabilisation measures would be broadly similar to that observed in developed market economies. This may help to explain the lack of early reforms of state enterprises and banks, and the slow pace of privatisation. Indeed, instead of discontinuing inefficient production, laying off excessive manpower and responding to market signals in a standard, profit-maximising way, state enterprises preferred to raise prices, protect employment and lobby heavily for government support and assistance.

From the economic perspective, the role of privatisation was to introduce efficient corporate governance and additional sources of funding for enterprises; in addition, and in many cases primarily, it was seen as an important underpinning of the political transformation. Very broadly, two different privatisation strategies were followed: one based on the free distribution of state assets to the public at large; the other following a case-by-case commercial approach. In the first case, the transfer of ownership rights can be carried out relatively fast, and the share of the non-state sector in the economy is expanded at the stroke of a pen. However, the main advantage of this method is essentially its speed: as for the economic objectives of privatisation, it takes much longer for effective corporate governance to be established. A good illustration of the problem is provided by the results of privatisation in the Czech Republic. Even though the state managed to divest itself of more than half its industrial property within less than three years, the behaviour of enterprises has in fact changed little if at all, because the new owners are either dispersed or, if they hold strategic stakes, are unable to exert the desired influence on managers because of a lack of information, conflict of interest or general passivity. The privatised enterprises are thus non-state, but they are not yet fully private. Moreover, only limited funds have been channelled to enterprises as a result of this method of privatisation.

Under the second strategy, when a state enterprise is sold to a new owner (owners), corporate governance is immediately established, additional financing is often forthcoming, and the necessary adjustments begin to follow; but since the strategy proceeds case by case, it takes a long time to privatise a majority of state enterprises. The dilemma is therefore to choose between a wide and shallow privatisation, or a deep and narrow one. Whatever alternative is selected, the process of economic restructuring will take years to complete.

One important lesson that can be drawn from experience is that a mixed strategy may be desirable, combining elements of free distribution and commercial sales. Another is that the rate at which corporate governance can effectively be established in newly privatised enterprises should be an important consideration determining the speed of the privatisation process. As proper governance cannot be achieved overnight, a large number of enterprises will have to stay and operate under non-private ownership for some time.

6 Banking reform

The need to overhaul the whole financial sector in the transition economies was only fully recognised when the banks and other financial institutions emerged as a major obstacle to the process of reform. The main weaknesses of the financial sector include: the absence of many important institutions of financial intermediation; the small capital base of the existing commercial banks; the excessive dependence of banks on a limited number of clients (mainly large state enterprises); lack of experience in credit operations; and either absent or inadequate prudential regulations and bank supervision. However, policymakers did not seem to fully realise that the reform of the financial system was not only an integral component in the creation of a market economy, but that it should have been initiated at the very beginning of the transformation process.

The failure to reform the financial sector at the start of the transition has had a number of important implications. The most important is probably the rapid accumulation of bad loans in the commercial banks, a phenomenon common to all the transition countries. Some of the bad loans are an inheritance from the regime of central planning, when state enterprises were largely unconstrained in their investment activities, but much more significant are those accumulated during the transition period. The latter resulted from a lack of appropriate adjustment by enterprises and banks to the sudden change in the macro-economic environment. Protracted recession and the collapse of traditional export markets in former Council for Mutual Economic Assistance (Comecon) countries also led to many technical and actual insolvencies in the enterprise sector.

7 Foreign investments

From the very beginning of the transition process, the governments of both Western countries and Eastern European countries regarded foreign direct investment as playing a key role in the restructuring and transformation of the former centrally planned economies. The initial optimism surrounding the role of FDI was based essentially on a number of perceived characteristics of the transition economies: an abundance of cheap skilled labour, geographical proximity to Western markets, the anticipation of a rapid growth of internal demand and liberal commercial legislation.

The balance after five years of transition looks rather modest. The actual volume of FDI in transition economies has been much lower than expected and, in addition, has been very unevenly distributed across countries. Apart from a few large investments in the early 1990s, foreign investment has tended to be hesitant and on a small scale.

One possible explanation of this outcome is that foreign investors picked up the best companies in Eastern Europe, in terms of their market potential, expected profits and the risks involved, and are not in a hurry to invest in other, typically more debt-ridden and overstaffed, companies. But a more general explanation for the reticence of foreign investors is probably linked to more general systemic factors, such as the uncertain legal, political and institutional environment.

Apart from limited inflows of FDI, its distribution may also be sometimes questionable. Casual observation and case studies suggest that FDI often tends to concentrate in sectors and branches with a relatively high potential for rent-seeking, which may arise from quasi-monopolistic positions or from special arrangements with the host governments of transition countries. Thus, foreign investment in Eastern European car manufacturing was typically made conditional on the granting of special privileges to investors in the form of high customs tariffs (in Poland for example).

8 The need for structural reforms

Despite marked differences in the history and rates of advance of market reform and in current macroeconomic performance, the transition countries of Eastern Europe display many similarities. Most of them have made considerable progress towards stabilising their economies, strengthening their domestic currencies and developing a strong and dynamic private sector. They have also managed to reorient much of their trade from the depressed Eastern markets to the more competitive markets of Western Europe. But these successes notwithstanding, the Eastern European countries also face some common problems which, if not addressed in an appropriate way, may hamper the economic recovery and even lead to political instability in the region. In particular, they are all confronted with essentially the same task of a massive reconstruction of their productive capacities, a task which includes a substantial reallocation of resources and probably the closing down of many inefficient enterprises. In this context, the slow pace of structural reforms raises serious concern. The implications, actual or anticipated, of restructuring for the distribution of income and wealth are a cause of bitter political infighting in most transition countries, which is also a factor slowing the progress of reforms. Improving the working of an inefficient and underdeveloped financial sector is also taking a great deal of time and effort, and the burden of bad debts has negative repercussions on the ability of the commercial banks to finance the enterprise sector.

As argued above, the economic performance of the Eastern European transition countries will also depend heavily on continued export expansion if overdependence on foreign capital is to be avoided or, since the latter seems unlikely to be available in significant amounts anyway, if the balance of payments is not to be a constraint on growth. Given the need for imports of new technology to support the restructuring process, an expanding capacity to import will therefore largely depend on the growth of exports. The positive impact of exports on growth may, however, be extended and strengthened if better access to Western European markets is granted for the transition countries, and this in turn may encourage an outward-looking FDI which can have a useful role to play in expanding exports over the longer term. But export growth can also be supported by export promotion efforts.

The other major constraint on growth is the relatively low rate of domestic savings, which limits the potential for domestically financed investment. This is not only due to the currently low level of per capita incomes in these countries. (It is worth noting that a considerable part of the household savings accumulated in the pre-transition period was wiped out by inflation and exchange rate changes.) Policies to encourage more savings are urgently needed in the transition countries. In this context, real positive interest rates on bank deposits are an important but not sufficient incentive. A variety of attractive and secure savings instruments needs to be developed, such as mutual funds, pension funds, bonds and equity shares. Also, accessibility of more expensive goods (consumer durables, housing) could be increased through the development of financial instruments, allowing people to save a larger proportion of their incomes in order to finance long-term purchases and investments (mortgages, consumer credits, and so on).

Economic prospects will also depend on the political developments in the transition economies. In this context, an important question is whether the almost universal shift of political support away from economic liberalism and political conservatism, which dominated the early years of transition, has implications for the direction and pace of economic reform. The shift of political power to the social democratic left started in Lithuania and in Poland in 1993, was followed by similar political changes in Bulgaria, Hungary and Slovakia in 1994 and, in early 1995, in Estonia. While most of the new governments displayed somewhat less enthusiasm for rapid, or spontaneous, privatisation (and, indeed, the pace of ownership transfers slowed down in some countries) there seems to be little question about their genuine commitment to continue with the process of market transformation and democratic reforms. But it is important to underline the problems facing these governments. After five years of reform, considerable progress has been made in transforming economies and political institutions, and in many of them the first signs of a recovery in output have appeared. Many people in Eastern Europe are benefiting considerably from this progress, especially the educated young, the skilled and those with entrepreneurial drive. But there are also many losers, especially the old, the unskilled, those employed by the state and many of those in the professions. Their growing discontent is now a factor that no government in Eastern Europe can ignore, and if their numbers continue to increase, then both social stability and the commitment to continued reform is likely to be undermined.

10 Conclusion

In 1989–90, the countries of Eastern Europe enthusiastically embraced the capitalist model of economic organisation. But since then, reservations have emerged and grown large, mainly because of the unexpected social and economic costs of transition and slow improvement in living standards. These reservations pose important challenges to policymakers: they call for imaginative domestic policies aimed at sustaining economic growth, checking and reversing the rising trend in unemployment, and speeding up the necessary structural change, while maintaining financial discipline and macro-economic stability. For political leaders, the current mood of disillusion creates a strong temptation to resort to populist measures, which could have disastrous economic consequences. Finally, popular reservations about the market reforms also pose a serious challenge to the international community, which should read them not simply as symptoms of impatience and naïveté on the part of Eastern European populations, but as the reflection of real social distress and, often, disorientation, conditions which call for more, not less, co-operation and solidarity with the transition economies.

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